# NEW EU FOREIGN DIRECT INVESTMENT SCREENING FRAMEWORK: A NEW TOOL FOR POLITICAL INTERFERENCE INTO M&A

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**Responding to calls from France, Germany and other Member States for stricter controls on foreign takeovers, the EU is about to adopt a new EU framework for the screening of foreign direct investment. Although the proposed legislation is reacting to the rise of Chinese investment into the EU in recent years, its impact will be felt more broadly. It will add a new layer of political scrutiny for cross-border M&A's to the existing regulatory approval process by EU competition authorities. The new FDI mechanism could also potentially be used to block US investments in Europe should Transatlantic trade relations continue deteriorating. All this in a moment in which M&A's have reached a record high in Europe and globally.**

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## Chinese Investments at the origin

The sudden increase in Chinese foreign direct investment into the EU over the past three years has alarmed political leaders in European capitals and brought the issue of Chinese takeovers to the forefront.

Chinese direct investment in the EU increased by 77% to EUR 35 billion last year. Investment in Germany alone reached EUR 11 billion in 2016 – more than the previous 10 years combined[1]. Meanwhile, European companies have scaled back their investments in China, wary of operating in what the EU Chamber of Commerce in China regularly describes as an increasingly difficult business environment. The resulting imbalance in FDI flows, with Chinese investment into the EU now four times as high as those from Europe to China. This has bolstered demands for greater reciprocity, and for stricter controls over Chinese investment in EU in sectors that remain closed to foreign companies in China.

[1] https://www.merics.org/en/merics-analysis/papers-on-china/cofdi/cofdi2017/#c17640

The nature of some of the deals that took place in the last couple of years has also raised fears in Europe, that much of the Chinese investment is linked to industrial policies promoted by Beijing, aiming to move the country up the value chain and compete with European companies for global market share. Many political leaders in Europe are worried that many takeovers, including Midea's acquisition of German robotics firm Kuka, seem to fit into Beijing's *Made in China 2025* strategy, which is designed to increase the share of core components that are made in China in ten specific industries[2]. The recent attempt by state-owned enterprise China Three Gorges to acquire Energias de Portugal (EDP) is also raising some question marks.

> *"We are open but not dumb."*
>
> Commissioner Günther H. Oettinger, reacting to the Kuka takeover

Doubts over the role of the Chinese government or state-owned enterprises regarding the takeovers of European firms have also raised national security concerns. For example, a bid by Chinese investors to acquire Aixtron, a German semiconductor equipment maker, failed in 2016 after the Obama administration stepped in, on the grounds that the firm is a key supplier of technologies with potential military applications.

Ironically, the time it has taken for European political leaders to react has created a situation in which the new screening framework is being introduced at the very moment regulators in China are cracking down on outbound investment. In late 2016, Beijing started introducing measures to curb "unreasonable" capital outflows to avoid a fall in foreign exchange reserves and consequent pressure on the renminbi. In the first half of 2017, China's outbound investment fell by 46% as a result[3]. However, while the fall is mainly concentrated in industries such as hospitality and entertainment, acquisitions in more strategic sectors have been more resilient.

## Conflicting Views in Europe

Within Europe, the national perspectives on the issue differ. A total of 12 Member States now have their own screening processes and other ones are considering setting-up similar mechanisms. France is one of the countries at the forefront of the initiative. Since in office President Macron had called for a European mechanism to vet and potentially block unwanted takeovers from non-European companies, especially China. France's push was particularly backed by Italy and Germany. Other traditional more pro-free trade members as the Scandinavian countries or The Netherlands are less supportive to the initiative.

Some Member States have also taken the matter into their own hands. Germany, for instance, has already presented an amendment to its existing foreign investment control framework (*Außenwirtschaftsverordnung*), which came into force in July 2017. The reform requires non-EU investors to notify the German government of investments in security-related technologies and critical infrastructure. The updated law also gives the federal economics ministry extended review periods, and the possibility to review an investment outside the industries explicitly identified.

One of the main objectives of the new EU framework is to provide a certain level of consistency preventing individual national initiatives from creating diverging frameworks across the continent.

## The Proposal: Member States Remain in Charge

The proposed Regulation[4], which is in final discussions by the 28 Member States and the European Parliament, establishes a framework for the screening of foreign direct investment on the grounds of security or public order, providing legal certainty to the Member States that maintain a screening mechanism, or wish to create one. Member States that do not have such a mechanism in place will not be forced to set one up.

> *"Let me say once and for all: We are not naïve free traders."*
>
> Jean-Claude Juncker, President of the European Commission

Specifically, the Regulation would clarify the ability of national governments to block investments in "critical infrastructure", "critical technologies", "the security of supply of critical inputs" and "access to sensitive

[2] http://news.xinhuanet.com/english/2015-05/19/c_134252230.htm
[3] http://www.scmp.com/business/global-economy/article/2102700/chinas-outbound-investment-slumps-46pc-first-half-amid
[4] https://ec.europa.eu/transparency/regdoc/rep/1/2017/EN/COM-2017-487-F1-EN-MAIN-PART-1.PDF

information of the ability to control sensitive information". In deciding whether an investment is likely to impact security or public order, "Member States and the Commission may consider whether the foreign investor is controlled by the government of a third country, including significant funding."

The proposal also establishes a cooperation mechanism to help the exchange of information among Member States and with the European Commission. It requires Member States to inform each other and the European Commission about any screening of foreign investment, and allows governments to request relevant information from foreign investors on a case-by-case basis. The proposal also aims to ensure that screening mechanisms meet a defined set of criteria such as non-discrimination between different third countries, transparency and the ability to challenge decisions in courts.

Interestingly, the proposed Regulation introduces the possibility for the European Commission to screen takeovers "of Union interest", such as acquisitions of projects or programmes that have received significant EU funding. However, although the Commission would be able to make recommendations to national governments, the final decision would remain in the hands of the Member States in which the investments take place– the Commission's role thus remains non-binding.

In addition, the text includes an "anti-circumvention" clause that will allow the screening of intra-EU takeovers, if it is clear that they are the result of a foreign investor trying to circumvent screening processes through "artificial arrangements within the EU that do not reflect economic reality".

In terms of timing, there is political will to find an agreement and formally adopt the legislation before the end of 2018. However, important differences between the Parliament and the Council on the scope and ambition of the text risk to lead to delays. For instance, the European Parliament is requesting the broadening of the definition of "security and public order". For their part, Member States are asking to have an 18-month transition period to adapt their legal systems to the changes introduced by the new EU framework once it gets into force.

## Conclusions

While the jury is still out regarding the exact scope and level of ambition of the new EU framework for FDI screening, there is a political resolve to increase investment protection in Europe and particularly in its largest economies (Germany, France and Italy). As a result of the increasing influence of China, the Dutch government is currently developing a strategy on China that will be presented in the first half of 2019.

New FDI screening trends in Europe will not only increase compliance costs for companies involved in M&A transactions but more importantly they will lead to additional uncertainty and delays. Until now the room for manoeuvre for EU and national authorities to block cross-border M&A has been limited and legal/regulatory considerations have largely prevailed. With the new framework, political considerations will be a much more important part of the equation. Additional uncertainty will be generated by the fact that both the EU and all national governments could raise objections to a given deal up to 15 months after the transaction is completed. To minimise the risks of delays and of political interference, it will be paramount to put in place a government relations and communications strategy that anticipates and addresses the political ramifications of the transaction.